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U.S. SENATE REPUBLICAN POLICY COMMITTEE

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A Path to Ruin: President Obama's Budget Borrows Too Much

Executive Summary

- CBO forecasts a record $1.8 trillion shortfall for this fiscal year, 13.1 percent of gross domestic product.
- President Obama's borrow, tax and spend policies would raise government spending above historic levels even after the stimulus and the aid to buttress our financial system have ended.
- The Obama budget runs deficits averaging nearly $1 trillion a year over the next decade.
- The Obama budget takes an already bad fiscal situation and makes it worse.
- The Obama budget proposes deficits consistently above 4 percent of the nation's gross domestic product (GDP) for the entire ten-year budget window.
- In 2004, now-OMB Director Peter Orszag argued that a persistent deficit of 3.5 percent of GDP put us on an "unsustainable path."
- By FY2019, the deficit would be 5.7 percent of gross domestic product and rising.
- Huge annual budget deficits would force the nation to borrow nearly $9.3 trillion over the next decade – $2.3 trillion more than the President claimed when he presented his budget a month ago.
- Net annual interest costs soar from $170 billion this year to $806 billion in FY2019, consuming 20 cents out of every dollar of federal revenue.
- Interest costs rise to a record of 3.4 percent of GDP by FY2017 and grow from there.
- In dollar terms, President Obama would double the public debt in five years and nearly triple it in ten.
- The public debt as a share of output would more than double from 40.8 percent of GDP last year to 82.4 percent of GDP in 2019; the last time public debt was that high was 1948.
- Ever-increasing debt as a share of national output is an unsustainable path.

President Obama's Budget Proposal Takes a Bad Fiscal Situation and Makes It Worse

- President Obama entitled the budget document he submitted to Congress "A New Era of Responsibility" and he has promised that he "didn't come here to pass on our problems to the next president or next generation."[1]

- The Congressional Budget Office (CBO) has estimated this "new era" begins with a $1.8 trillion shortfall this fiscal year which is 13.1 percent of Gross Domestic Product (GDP). This is debt that will be paid off by the next generation.

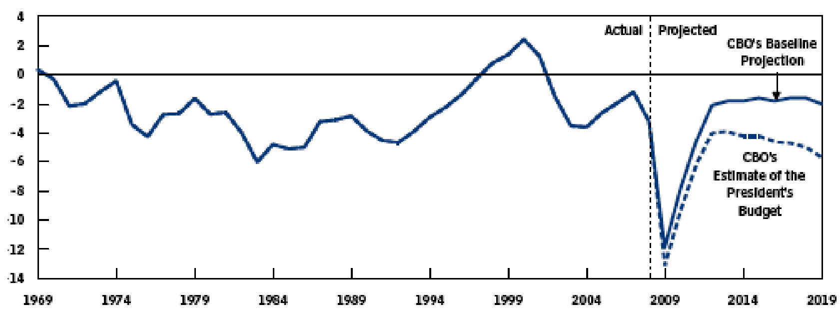
- Instead of putting the United States on a course towards fiscal sustainability, the "new era of responsibility" borrows nearly $9.3 trillion over the next ten years, promises budget deficits of at least 4 percent of GDP each year for the next ten years, and projects annual deficits reaching 5.7 percent of GDP and rising by 2019.[2]

- The $9.3 trillion in deficits includes an additional $4.8 trillion in new debt proposed by President Obama and is $2.3 trillion more than the President claimed when he presented his budget a month ago

Chart 1 from CBO shows the Total Deficit as a Percent of GDP in two lines. The solid blue line shows the projected deficit in the CBO baseline; this is the deficit if no new legislation were enacted and President Obama's budget did nothing at all. The dotted blue line shows the projected deficit if all of President Obama's plans were enacted into law as proposed.

Total Deficits or Surpluses, 1969 to 2019

(Percentage of gross domestic product)



Source: Congressional Budget Office.

Before the Obama Administration even came into office, the Congressional Budget Office had projected significant deficits driven by the enormous costs of the United States' unfunded liabilities. These liabilities included unsustainable Social Security, Medicare, and Medicaid

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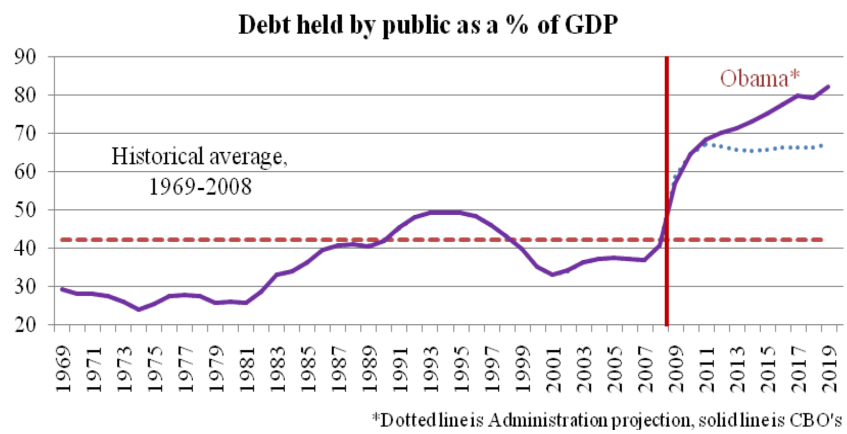
[1] The White House, Office of the Press Secretary, President's Weekly Address-Saturday, March 21, 2009: http://www.whitehouse.gov/the_press_office/Weekly-Address-President-Obama-to-Focus-on-Budget-Priorities-Next-Week/

[2] CBO Historical Budget Data, "The Budget and Economic Outlook: Years 2009-2019," available at: http://www.cbo.gov/doc.cfm?index=9957

programs. As the CBO under Director Orszag warned many times, total future obligations for these programs will rise from 8.4 percent of GDP in 2007 to 18.1 percent of GDP in 2050, absorbing nearly as much national income as the entire federal budget does today.[3] President Obama's budget fails to improve the solvency of these programs, and instead adds new liabilities including a new refundable tax credit and an unspecified new government health care obligation; these new programs have nothing to do with addressing the economic crisis that began in 2008.

Obama's Deficits Put Us on an Unsustainable Path

By borrowing nearly $1 trillion **a year** over the next decade, President Obama would double the debt held by the public (money the government has to pay back to those who lend to the government domestically or from abroad) in five years and nearly triple it in ten years. Nominal public debt is projected to go from $5.8 trillion in 2008 to $17.3 trillion in 2019, and more than double as a share of GDP from 40.8 percent last year to 82.4 percent of GDP in 2019.[4]



It is important to note that these dangerously high deficits were not inherited and don't account for the full cost of the president's agenda; for example, recent estimates show the expected cost of the president's health care plan could reach $1.5 trillion while the president's budget only sets aside about $600 billion for health reform in a "reserve fund."[5] While the president has

[3] CBO, "The Long-Term Budget Outlook," December 2007, available at: http://cbo.gov/ftpdocs/88xx/doc8877/12-13-LTBO.pdf; Medicare and Medicaid alone will consume 19 percent of GDP in 2082 (see Testimony of Peter Orszag before the Committee on Finance, United States Senate, "The Long-Term Budget Outlook and Options for Slowing the Growth of Health Care Costs," June 18, 2008 at http://www.cbo.gov/ftpdocs/93xx/doc9385/06-17-LTBO_Testimony.pdf); the estimated size last year of Social Security's unfunded liability alone is $13.6 trillion and is likely to be revised upward when the 2009 Trustees report is released (see "The 2008 OASDI Trustees Report," figures II. D2. II. D4, and II. D5, available at http://www.ssa.gov/OACT/TR/TR08/II_project.html#105057).

[4] In addition to outstanding debt held by the public, the government also issues debt to itself through entities such as the Federal Reserve Bank and the Social Security Trust Fund. Since this is debt the government will pay back to itself, the roughly $4.3 trillion in these accounts is not as important a measure as the debt held by the public. This debt does count against the government's statutory debt limit, however. All told, outstanding federal debt held by the public and in government accounts passed $11 trillion for the first time ever the week of March 16th, 2009

[5] "Health care overhaul cost may reach $1.5 trillion." Ricardo Alonso-Zaldivar, *Associated Press*. Wednesday, March 18, 2009: http://news.yahoo.com/s/ap/20090318/ap_on_go_pr_wh/health_overhaul_cost

promised his budget "cuts our deficit in half by the end of my first term,"[6] this is an empty promise since he is beginning from an enormous deficit and cuts it "in half" to a historically large deficit of $658 billion, or 4.2 percent of GDP.

President Obama's current budget director, Peter Orszag, has been one of the best and most consistent voices sounding the alarm on unsustainable levels of national debt. His past research and public statements make a very convincing case that the budget he has now put together is a dangerous course that helps to lead the country towards fiscal ruin. Orszag has argued that increases in budget deficits "reduce national savings and therefore reduce future national income, regardless of their effect on interest rates."[7]

Orszag argued in 2004 that a persistent deficit of 3.5 percent of GDP put us on an "unsustainable path."[8] Back then, economist Orszag, in a paper with a colleague from the Brookings Institution, warned that deficits of 3.5 percent of GDP, significantly smaller than the smallest deficits predicted in President Obama's budget, would decrease annual national income "by 1 to 2 percent, (or roughly $1,500 to $3,000 per household per year, on average)," and increase average long-term interest rates 80 to 120 basis points. Economist Orszag wrote, "Sustained, chronic deficits will gradually reduce national income and living standards, and carry with them the risk of a fiscal crisis…"[9] Despite this warning from his top budget adviser, President Obama significantly worsens the risk of a "fiscal crisis" by proposing additional deficits of $4.8 trillion over the next ten years.

Debt Holders Could Lose Confidence

In 2004 Orszag warned that "Chronic, substantial deficits can cause a fundamental shift in market expectations and a related loss of confidence both at home and abroad. The scale of the long-term fiscal gap is so large that, if left uncorrected, the nation faces a real risk of a fiscal crisis." The risk of "a related loss of confidence" is already becoming apparent. Foreign nations that have large pools of savings hold roughly $3.1 trillion of the outstanding $5.8 trillion in U.S. public debt.[10] The chart below shows the largest foreign holders of U.S. debt.

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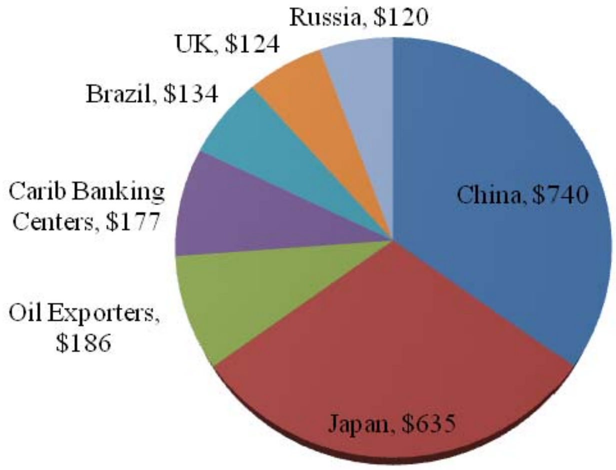
[6] The White House, Office of the Press Secretary, President's Weekly Address-Saturday, March 21, 2009.
[7] Gale, William G. and Orzag, Peter R. (2003), "The Economic Effects of Long-Term Fiscal Discipline," Discussion Paper No. 8: http://www.taxpolicycenter.org/UploadedPDF/310669_TPC-DP8.pdf
[8] Gale, William, G. and Orszag, Peter R. (2004). "The U.S. Budget Deficit: On an Unsustainable Path," *New Economy*, December 2004: http://www.brookings.edu/views/articles/20041201orszaggale.pdf
[9] Gale, William G. and Orszag, Peter R. (2004) "The Budget Outlook: Projections and Implications," *The Economists' Voice*: Vol. 1: Iss. 2, Article 6., available at http://www.bepress.com/ev/vol1/iss2/art6
[10] Department of the Treasury/Federal Reserve Board, March 16, 2009. Major Foreign Holders of Treasury Securities: http://www.ustreas.gov/tic/mfh.txt

Largest Foreign Holders of U.S. Treasury Securities
(January 2009, dollar amounts in billions)



China has been the most important source of foreign funding for the very large U.S. debt. Although some have expressed concern that China may start selling their large U.S. holdings, this is unlikely as large sell-offs by the Chinese would seriously damage the value of their own portfolio of U.S. assets. As an analysis from the St. Louis Fed recently pointed out, "The more grave risk is that investors in U.S. Treasury debt, foreign or domestic, would lose faith in the ability of the U.S. government to meet its obligations in the face of unsustainable, long-run structural deficits."[11]

Signs of this loss of faith are beginning to emerge. Chinese Premier Wen Jiabao recently called on the United States to "maintain its credibility, honor its commitments and guarantee the safety of Chinese assets."[12] The issue of "credibility" will be key going forward if the United States wants foreigners or anyone else to continue financing our large deficits. A budget that piles $4.8 trillion in borrowing on top of projected $4.4 trillion already in the CBO baseline is not credible.

Borrowing So Much Now Leaves Us Vulnerable

The largest threat from borrowing too much comes from the expense of doing so. Amassing debts today means they have to be paid back tomorrow. In the words of Peter Orszag, "The government cannot continue to run deficits so large that the public debt grows faster than output." Such large deficits introduce significant uncertainty into the economic outlook since these deficits will have to be paid back in one of three ways: cutting spending programs, raising taxes, or through inflation.

In the extreme case, if a nation is unwilling to take these steps, its ability to honor its debts will be cast into doubt. As this happens the price demanded by investors for loaned funds will rise,

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[11] Deficits, Debt and Looming Disaster: Reform of Entitlement Programs May Be the Only Hope," Michael Pakko, Federal Reserve Bank of St. Louis publication *The Regional Economist*, January 2009: http://www.stlouisfed.org/publications/re/2009/a/pages/debts.html

[12] "Wen Voices Concern Over China's U.S. Treasuries," *The Wall Street Journal*, March 13, 2009. http://online.wsj.com/article/SB123691285879115803.html

interest rates will go up, and the cost of funding government operations will get ever more expensive. Net interest payments cost the United States only 1.7 percent of GDP in 2008;[13] CBO projects that net interest payments will rise throughout the next decade to 2.9 percent of GDP in 2019. This means the U.S. will spend $4.8 trillion in net interest over the next decade, one third of the amount projected to be spent on all discretionary programs over the same timeframe.

Borrowing at this level means that the government will not have the credibility to keep borrowing at cheap rates. Again, research by the president's current budget director argues that "increases in expected future deficits raise long-term interest rates."[14] Eric Engen and Glenn Hubbard estimate that raising the ratio of federal debt to GDP by ten percentage points would increase long-term interest rates 23.7 basis points.[15] The Obama budget raises the federal debt to GDP ratio 42 percentage points. Large existing deficits can also prevent a nation from acting in the case of an emergency. For example many European nations cannot enact fiscal stimulus programs because they cannot afford to increase their debt/GDP ratio.[16]

Conclusion

The dangers posed by President Obama's budget are not dangers that will be faced by the next generation – they are dangers that will be faced today. Without a credible commitment to controlling long-term deficits, creditors will start to question the U.S.'s ability to pay down its obligations. As debt piles up and interest rates rise, financing these deficits will become more expensive until the United States will be forced to make real choices regarding which programs to cut, which taxes to raise, and how much inflation is tolerable to maintain our ability to fund the government. These choices, which will be made under an increasingly dire fiscal situation, could include harmful tax increases on American businesses and the middle class. By adding expensive new programs for a nation that cannot afford them, President Obama's failure to make tough choices today has the potential to set our economy on a path to ruin.

[13] CBO Historical Tables of the Budget, Revenues, Outlays, Surpluses, Deficits, and Debt Held by the Public, 1969 to 2008, available at: http://www.cbo.gov/ftpdocs/99xx/doc9957/Historicaltables09-web.XLS
[14] Gale, William G. and Orszag, Peter R. (2004) "The Budget Outlook: Projections and Implications," *The Economists' Voice*: Vol. 1: Iss. 2, Article 6., available at http://www.bepress.com/ev/vol1/iss2/art6
[15] Eric Engen and Glenn Hubbard, "Federal Government Debt and Interest Rates," NBER Working Paper 10681, issued August 2004; while Engen and Hubbard focus on the debt, a 2003 Fed paper that found a one percentage point increase in the projected deficit-to-GDP ratio is estimated to raise interest rates by 25 basis points. The Fed paper is available here: http://www.federalreserve.gov/pubs/feds/2003/200312/200312abs.html
[16] "Italy's Debt Burden," *The Economist*, February 11, 2009: http://www.economist.com/displaystory.cfm?story_id=13096792